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Self-Employment Tax

For use in preparing
1985 Returns

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Introduction

The self-employment tax is a social security tax for individuals who work for themselves. It is similar to the social security tax withheld from the pay of wage earners.

Social security benefits are available to individuals who are self-employed just as they are to wage earners. Your payments of self-employment tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits and with hospital insurance benefits (Medicare).

Income limits. You must pay self-employment tax if you have net earnings from self-employment of \$400 or more. (You must also pay self-employment tax if you are paid \$100 or more in a year as an employee of a church or qualified church-controlled organization exempt from social security taxes.) For 1985 the maximum amount subject to self-employment tax is \$39,600. (The 1986 maximum amount is \$42,000). However, no self-employment tax is due on your self-employment income if the wages you received in 1985 as an employee were \$39,600 or more, and were subject to either social security tax or railroad retirement tax, or both.

Note: If you were a U.S. Government employee subject only to the 1.35% hospital insurance benefits tax, and your combined wages and self-employment earnings were in excess of \$39,600, compute your self-employment tax by using the worksheet in the Form 1040 instructions for Schedule SE.

Tax rates. The self-employment tax rate for 1985 is 14.1%. However, you will pay at a tax rate of only 11.8% in 1985 because a credit is applied against the amount of your self-employment tax equal to 2.3% of your self-employment income. For 1986, the self-employment tax rate will increase to 14.3%; the credit will decrease to 2%; and you will pay self-employment tax at a net rate of 12.3%.

Forms. Form 1040, *U.S. Individual Income Tax Return*, is used to report self-employment tax. Both income tax and self-employment tax are due at the same time. A separate schedule of Form 1040, Schedule SE, *Computation of Social Security Self-Employment Tax*, is used to figure the tax. The tax, itself, is reported on line 51 of Form 1040. Even if you are not otherwise required to file an income tax return, you must file both Form 1040 and Schedule SE to pay self-employment tax.

Joint returns. You cannot file a joint Schedule SE (Form 1040) even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has self-employment income, his or her income is independently subject to the self-employment tax. If you both have self-employment income, each of you must file a separate Schedule SE (Form 1040). (See *Husband and wife partners*, later.)

Community income. If any of the income from a trade or business other than a partnership is community income under state law, it is subject to self-employment tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or business is determined based on the facts in each situation.

Social security number. You must have a social security number if you have to pay self-employment tax. If you do not have a number, you should apply for one on Form SS-5, *Application for a Social Security Number Card*. You can get this form at any Social Security office and from the Internal Revenue Service.

If you now have a social security number, even if you got it when you were an employee, you should not apply again.

If you had a number but lost your card or any record of your number, you should file Form SS-5, showing where and about when you first applied for it. You will get your original number, not a new one.

Estimated income tax. You may be required to pay estimated tax. This depends on how much you expect your income to be for the year and how much of it will be subject to withholding tax. You must also figure any self-employment tax you will owe.

If you have a regular job, you may cover your estimated self-employment tax payments by having your employer increase the amount of income tax withheld from your pay.

You may have to pay a penalty if you do not pay the correct installment of estimated tax by its due date. For more information, see Publication 505, *Tax Withholding and Estimated Tax*, available from the Internal Revenue Service.

Social security benefits. For an explanation of the benefits available to you and your family under the social security program, consult your nearest Social Security Administration office.

Who Must Pay the Tax

If you carry on a *trade or business*, except as an employee, you probably have to pay self-employment tax. A trade or business is generally an activity that is carried on for a livelihood, or in good faith to make a profit. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business. Regularity of activities and transactions and the production of income are important elements.

The facts and circumstances of each case determine whether or not an activity is a trade or business.

You may be liable for paying self-employment tax even if you are now fully insured under social security or are now receiving benefits.

Self-Employment Income

You are probably self-employed if you are a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself.

You do not have to carry on regular full-time business activities to be self-employed. Part-time work, including work you do on the side in addition to your regular job, may also be self-employment.

Some different kinds of self-employment are discussed below—

Sideline. You work in your spare time fixing televisions and radios. You have your own shop, equipment, and tools. Your customers come from advertising and word-of-mouth. The income you earn from the repair shop is self-employment income.

Professional. The income that a doctor, as a sole practitioner, receives from the practice of medicine is earnings from a trade or business. It is self-employment income.

Independent contractor. An individual doing bookkeeping and related services for several clients as an independent contractor is engaged in a trade or business. The income from this work is self-employment income.

You are not an independent contractor if you perform services that can be controlled by an employer (what will be done and how it will be done). If an employer-employee relationship ex-

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ists (it does not matter what the relationship is called), you are not an independent contractor. **Partner.** Two brothers own and run a fruit stand together as partners. Each of them must include his distributive share of income or loss of the partnership in his self-employment income. (See *Husband and wife partners* on this page.)

Sole proprietor. You are a baker who owns and operates a cake and donut shop as a sole proprietor. Your income from the shop is self-employment income. (If your spouse works with you in your business, see *Husband and wife partners* on this page.)

Research grants. An individual who receives payments under a research grant from a governmental foundation but who is not under the control of either the grantor foundation or the grantee institution is carrying out the research project as an independent contractor. The payments received by the individual are self-employment income.

Real estate agents and direct sellers. Income received by a licensed real estate agent or a direct seller may be considered self-employment income for federal income and employment tax purposes. Generally, a licensed agent or a direct seller is treated as self-employed if (1) substantially all remuneration (whether or not in cash) paid for services as a real estate agent or a direct seller is directly related to sales or other output rather than hours worked and (2) the services are performed under a written contract and such contract provides that the agent or seller will not be treated as an employee for federal tax purposes. For more information, see Publication 539, *Employment Taxes*, and Publication 911, *Tax Information for Direct Sellers*.

Fishing crew members. Certain members of the crew working on a boat that catches fish or other forms of water animal life are self-employed if:

- 1) The members do not get and are not entitled to get any money for their work (other than their share of the proceeds from the sale of the catch),
- 2) They get shares of the catch or shares of the proceeds from the sale of the catch,
- 3) Their shares depend on the amount of the catch, and
- 4) The operating crew usually numbers less than ten individuals.

If these conditions are met, the crew members are considered self-employed and must pay self-employment tax and make estimated tax payments. For further information, see Publication 595, *Tax Guide for Commercial Fishermen*.

Payment in kind (PIK). A commodity received from the Department of Agriculture by a self-employed farmer or a landlord materially participating in a farm is self-employment income to the farmer or landlord. The payment the landlord or farmer gets is for participation in the PIK program.

Executor or administrator. If you administer a deceased person's estate, your fees are earnings from self-employment if you, the fiduciary (that is, the executor or administrator), are:

- 1) A professional fiduciary,
- 2) A nonprofessional fiduciary (personal representative) who manages an estate that includes an active trade or business, if you actively participate in the business and receive fees related to the operation of the trade or business, or
- 3) A nonprofessional fiduciary of a single estate that requires extensive managerial activities on your part for a long period of time, but only if these activities are enough to be considered a trade or business.

Employee of a church or church-controlled organization. Beginning in 1984, if you work for a church or a qualified church-controlled organization that elected exemption from social security taxes, you will have to pay self-employment tax on amounts paid to you by the church or organization if \$100 or more in a year.

Corporate employee. Even if you own most or all the stock of a corporation, your income as an employee or officer of the corporation is not self-employment income.

However, fees received for performing services as a director of a corporation are self-employment income. It does not matter whether the fees are for going to directors' meetings or for serving on committees.

An honorary director of a corporation who served as an active director for several years but is no longer required to perform services must include the fees received from the corporation in self-employment income. The fees are attributable to prior services.

Member of an unincorporated organization. Generally, income you receive as a member of an unincorporated organization that has certain corporate characteristics and that is classified as an association taxable as a corporation is not self-employment income. See Publication 542, *Tax Information on Corporations*.

Public officials. Public officials generally do not pay self-employment tax on what they earn in their official positions. Public office includes any elective or appointive office of the United States or its possessions, the District of Columbia, a state or its political subdivisions, or a wholly owned instrumentality of any of these.

An elected tax collector who is paid from state funds on the basis of a fixed percentage of the taxes collected does not have income from self-employment.

However, public officials of state or local governments must pay self-employment tax on their fees if they are paid solely on a fee basis and if their services are eligible for, but not covered by, social security under a federal-state agreement.

Dealers in options and commodities. Dealers in options and commodities must treat as net earnings from self-employment gains and losses from dealing or trading in section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options), or property related to such contracts such as stock used to hedge options. See sections 1256 and 1402(i) of the Internal Revenue Code.

Aliens. Nonresident aliens do not have to pay self-employment tax. Residents of the Virgin Islands, Puerto Rico, Guam, or American Samoa, however, are subject to the tax. For self-employment tax purposes, they are not considered nonresident aliens.

Nonresident and resident aliens employed in the United States by an international organization, a foreign government, or a wholly owned instrumentality of a foreign government are not subject to self-employment tax. U.S. citizens employed under the same circumstances are subject to self-employment tax if they are exempt from the social security employee tax.

U.S. citizens operating a business in U.S. possessions. If you are a U.S. citizen who owns and runs a business in Puerto Rico, Guam, the Northern Mariana Islands, American Samoa, or the Virgin Islands, you must pay self-employment tax. You must pay the tax even if you are exempt from U.S. income tax. Unless one of the following special income tax rules applies, use Schedule SE (Form 1040) to figure your tax.

- 1) Report your self-employment tax on Form 1040SS for income from sources in:
 - a) Guam and the Northern Mariana Islands,

If you are residing in one of those areas on the last day of your tax year, or
b) Virgin Islands, if you are a bona fide resident and pay no income tax to the United States.

Note: Form 1040SS (NMI) is now used by self-employed individuals covered under the Northern Mariana Islands Social Security Law.

- 2) Report self-employment tax on Form 1040SS, or 1040PR when appropriate, for income from sources in Puerto Rico if you are not required to file Form 1040 with the United States.

File all these forms with the Internal Revenue Service Center, Philadelphia, PA 19255. For more information on U.S. citizens in U.S. possessions, see Publication 570, *Tax Guide for U.S. Citizens Employed in U.S. Possessions*.

Partnerships

If you are a member of a partnership that carries on a trade or business, your distributive share of partnership income is income you earned from self-employment. Any loss from a partnership reduces your net earnings from your other trades or businesses. Guaranteed payments you get from your partnership should be included, along with your share of earnings or minus your share of losses when you figure your net earnings from self-employment.

If your partnership is engaged in oil production and you receive a refund of windfall profit tax that you deducted in an earlier year, you should include the amount of the refund in figuring your net earnings from self-employment.

If your partnership took a deduction for recovery property under section 179 of the Internal Revenue Code in an earlier year, you should increase your self-employment earnings by section 179 recapture amounts caused by a drop in business use to the extent that you took a section 179 deduction.

An inactive partner figures income from self-employment by including the distributive share of partnership income or loss and any guaranteed payments.

A limited partner figures self-employment income by excluding the distributive share of partnership income or loss. But guaranteed payments, such as salary and professional fees, received for services performed during the year are included as self-employment income.

A retired partner pays no self-employment tax on retirement income received from the partnership under a written plan if:

- 1) The retired partner receives life-long periodic payments,
- 2) The retired partner's share of the capital of the partnership has been fully repaid to the retired partner,
- 3) The retired partner performs no services for the partnership during the year, and
- 4) The partnership owes the retired partner nothing but the retirement payments.

Husband and wife partners. You and your spouse may operate a business as a partnership. If you and your spouse join together in the conduct of a business and share in the profits and losses of this business, a partnership has been created. You and your spouse must report the business income on a partnership return, Form 1065, attach Schedules K-1 to Form 1065 to show each partner's share of the net income, and file separate Schedules SE (Form 1040) to report the self-employment tax.

The services of an individual who works for his or her spouse are not subject to the self-employment tax or to the social security tax.

Investment club partnership. A member's dis-

tributive share of the income from an investment club partnership that limits its activities to investing in savings certificates, stock, or securities and collecting interest or dividends for its members' accounts is not self-employment income. The partnership is not engaged in a trade or business.

Different tax years. If your tax year is not the same as your partnership's, report your distributive share of partnership income or loss on your return for the year that includes the end of the partnership tax year.

Example. You file your return on a calendar year basis, but your partnership uses the fiscal year ending January 31. You must include your distributive share of partnership earnings and your guaranteed payments for the fiscal year ending January 31, 1985, in your return for the calendar year 1985.

Death of a partner. When a partner dies, his or her distributive share of partnership income is figured through the end of the month in which the death occurs. This is true even though the decedent's estate or heirs may succeed to rights in the partnership. The partnership income for the year is treated as if it were earned in equal amounts each month.

Example. A partner's distributive share of profits for the partnership year ending June 30, 1985, was \$8,000. The partner, who filed a return on a calendar year basis, died on August 18, 1985. For the partnership year ending June 30, 1986, the distributive share to the partner and the partner's estate is \$12,000. The deceased partner's self-employment income for 1985 is \$8,000 plus \$2,000 (2/12 of \$12,000), or \$10,000.

For additional information on figuring your income from a partnership, see Publication 541, *Tax Information on Partnerships*.

Religious Exemptions

Generally, every self-employed person must pay self-employment tax. However, members of some religious sects, ministers, Christian Science practitioners, and members of religious orders may obtain an exemption if they meet certain requirements.

Members of recognized religious sects opposed to insurance. If you belong to a recognized religious sect or a division of such sect that is opposed to insurance, you may qualify for an exemption from the self-employment tax. To qualify, you must be conscientiously opposed to accepting the benefits of any public or private insurance that makes payments because of death, disability, old age, or retirement, or makes payments toward the cost of, or provides services for, medical care (including social security benefits). If you buy a retirement annuity from an insurance company, you will not be eligible for this exemption. Religious opposition based upon the teachings of the sect is the only legal basis for the exemption. In addition, your religious sect (or division) must have existed since December 31, 1950.

To get the exemption, you must file an application, Form 4029, *Application for Exemption from Tax on Self-Employment Income and Waiver of Benefits*, and waive all social security benefits.

Members of religious orders who have taken a vow of poverty. If you are a member of a religious order and you have taken a vow of poverty, you are automatically exempt from self-employment tax for any amount you receive while working for your church or an agency of your church. You do not have to file for an exemption. However, if you work for an outside organization, you are a regular employee of that organization for federal employment tax purposes (federal income tax withholding, social security, and federal unemployment tax).

The exemption from self-employment tax does not apply to the amount earned from the outside employment.

Ministers, Christian Science practitioners, and members of religious orders who have not taken a vow of poverty. Members of religious orders who have not taken a vow of poverty, Christian Science practitioners, and ministers are subject to the self-employment tax unless they request an exemption. You can get an exemption by timely filing an application that states that you are conscientiously opposed to accepting, for services performed as a minister, practitioner or member, any public insurance that makes payments because of death, disability, old age, or retirement, or makes payments toward, or provides services for, medical care (including social security benefits). Your opposition must be based on the principles and discipline of your particular religious denomination, or it must be based on your own religious considerations. Exemptions are not given for nonreligious reasons of conscience. The exemption, once obtained, cannot be revoked.

The exemption applies only to services performed by an ordained, commissioned, or licensed minister of a church in the exercise of the ministry. This includes the ministration of sacerdotal functions, the conduct of religious worship, and the control, conduct, and maintenance of religious organizations under the authority of the church or church denomination. If a minister performs service in the conduct of religious worship or the ministration of sacerdotal functions, such service is in the exercise of the ministry whether or not it is performed for a religious organization.

Example. John Smith, an ordained minister, performs services as the chaplain at a private university. He devotes all his time to his duties as chaplain, which include the conduct of religious worship, offering spiritual counsel to the university students, and teaching a class in religion. John Smith is performing services in the exercise of his ministry.

Government employees. Services performed by a qualified minister as an employee of any governmental body are not considered to be in the exercise of the ministry for self-employment tax purposes, even though such services may involve the ministration of sacerdotal functions or the conduct of religious worship.

For example, services performed by an individual as a chaplain in the Armed Forces of the United States are considered to be performed by a commissioned officer and not by a minister in the exercise of the ministry. Similarly, services performed by an employee of a state as a chaplain in a state prison are performed by a civil servant of the state and not by a minister in the exercise of the ministry.

A member of the clergy who is now performing duties in the exercise of the ministry and who has retired from military service as a chaplain may qualify for this exemption. The minister or chaplain qualifies for the exemption even if that individual is getting military retirement pay for prior service as a chaplain in the Armed Forces.

How to obtain the exemption. To get the exemption, you should file Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*.

When to apply. An individual entering the ministry either as a minister, a member of a religious order, or a Christian Science practitioner must file an application by the due date for filing an individual income tax return for the second tax year in which the individual has \$400 or more of net earnings from self-employment of which some were earnings from the ministry.

The right of an individual to file an application for exemption ceases upon death. Therefore, the surviving spouse, executor, or administrator may not file an application for exemption for a deceased member of the clergy.

Net earnings. If you do not receive the exemption, you must figure your net earnings from self-employment. To figure this amount for services performed as a minister, a Christian Science practitioner, or a member of a religious order, deduct all expenses that relate to your duties, such as clerical help and transportation. Contributions you make to an individual retirement plan are not deductible expenses in figuring net earnings for self-employment tax.

Include in net earnings the rental value of a parsonage or rental allowance provided to you as part of your pay. Also include the value of meals and lodging provided to you in connection with your services. The fact that these items are included in self-employment income does not affect their status for income tax purposes.

For more information see, Publication 517, *Social Security for Members of the Clergy and Religious Workers*.

Figuring the Tax

If you were self-employed during the year, you must figure how much of your income is subject to self-employment tax. There are three steps to figure how much tax you owe.

- 1) Determine your net earnings from self-employment.
- 2) Determine how much of those net earnings are subject to the tax.
- 3) Multiply that amount by the tax rate.

When figuring your net earnings, you should include only income and expenses that come about in the regular course of your trade or business. There are three ways to figure self-employment net earnings. They are the regular method, the farm optional method, and the nonfarm optional method. The regular method is the method most often used.

The two optional methods are intended to permit continued coverage for self-employment tax purposes when your net profit for the year is small or you have a loss. The optional methods are used only to figure self-employment tax. Do not use them to figure your income tax.

The three methods differ in the way you determine net earnings. However, the kinds of excluded income and deductions, the minimum and maximum income limits, and the tax rate are the same for each of the three methods. The general rules for figuring self-employment tax are presented in the discussion of the *Regular Method*.

Regular Method

There are no limits on who may use the regular method. Most taxpayers use this method.

Step 1. Figure what your net earnings from self-employment are. Under the regular method, the net income from your business or profession is generally your net earnings from self-employment. Net income is figured by subtracting all allowable business expenses and deductions from gross business income.

If you have more than one trade or business, your net earnings from self-employment are the combined net earnings from each of your businesses. A loss in one business will reduce the income earned in another.

You must claim all allowable deductions, including depreciation, when figuring your net earnings from self-employment. Making false statements to get or to increase social security benefits may subject you to penalties.

If you recaptured any amounts under sections 179 and 280F of the Internal Revenue Code because the business use of the property dropped to 50% or less, these amounts are subject to the self-employment tax. (This does not include amounts recaptured on the disposition of property.) For more information, see the instructions for Form 4797, *Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business and Involuntary Conversions (And Computation of Recapture Amounts Under Sections 179 and 280F)*.

If you elect to use the targeted jobs credit, your wage and salary expense deduction must be reduced by the amount of the credit when you figure your net earnings from self-employment.

Net earnings from self-employment normally include all of the items of business income and deductions allowed for income tax purposes. However, there are certain kinds of income and deductions you do not take into account in figuring your net earnings from self-employment, even though they are included in figuring your income tax. Some of them are listed below—

Real estate rent. Rent from real estate and from personal property leased with real estate is not self-employment income. However, if you are a real estate dealer and the rent is received in the course of your trade or business, the rental income and related deductions are included in figuring self-employment income.

Rents received for the use or occupancy of hotels, boarding houses, or apartment houses are not rentals from real estate if services are provided for the occupants. These rental payments, therefore, are included in figuring net earnings from self-employment. Generally, services are provided for the occupants if they are primarily for the convenience of the occupants and are not services that are normally provided with the rental of rooms or space for occupancy only. Maid service, for example, is a service provided for the convenience of the occupants. However, heat and light, the cleaning of stairways, exits, and lobbies, and the collection of trash are not.

Rent received by trailer park owners who provide trailer lots, facilities, and services is rent from real estate and is not included in self-employment income unless the services the owners provide are substantial and for the convenience of their tenants. Providing services, such as city sewerage, electrical connections, and roadways, are services required to maintain space for tenant occupancy and not services for the convenience of tenants. Although the operation and maintenance of a trailer park laundry facility is a service provided for the convenience of the tenants, this service, by itself, is not substantial.

If, however, the owners provide services for the convenience of their tenants, such as supervising and maintaining a recreational hall provided by the park and consisting of a card area, pool room, kitchen, auditorium, stage, and library, distributing a monthly newsletter to the tenants, operating a laundry facility, and helping the tenants buy or sell their trailers, these services are beyond those required for occupancy, and are substantial in nature. Income received by owners providing substantial services is includible in computing self-employment net earnings.

Interest. Interest is not self-employment income unless you receive it in your trade or business, such as interest on accounts receivable.

Dividends. Dividends on securities are not self-employment income unless you are a dealer in securities.

Capital gains and losses. Capital gains and losses, such as gain or loss on the sale of investment property, are excluded from self-employment income.

Other gains and losses. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included when figuring self-employment income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included:

- 1) Depreciable property or other fixed assets used in your trade or business.
- 2) Livestock held for draft, dairy, breeding, or sporting purposes, and not held primarily for sale, regardless of how long the livestock was held, or whether they were raised or purchased.
- 3) Standing crops sold with land held more than one year.
- 4) Timber, coal, or iron ore held for more than one year, if an economic interest has been retained, such as a right to receive coal royalties.
- 5) The cutting of timber, if it is treated as a sale or exchange.

S corporations. If you are a shareholder in an S corporation, your share of the corporation's taxable income is not self-employment income, even though you include it in your gross income for income tax purposes.

Wages and salaries. Wages that are received for services performed as an employee and that are covered by social security tax or by railroad retirement tax are not self-employment income. Also, tips received for work done as an employee are excluded from self-employment income.

Deductions and exemptions. Your self-employment income should not be reduced by certain deductions and exemptions that are used when figuring income tax. Specifically, do not use:

- 1) Deductions for personal exemptions for yourself, your spouse, or dependents,
- 2) The zero bracket amount,
- 3) The net operating loss deduction,
- 4) The foreign expropriation loss deduction, and
- 5) Nonbusiness deductions including contributions on your behalf to a pension, profit-sharing, or annuity plan.

Example. You own a grocery store and for the year your business has the following items:

Gross profit on sales.....	\$87,400
Salaries.....	30,000
Rent.....	6,000
Heat, light, and air conditioning.....	2,400
Other expenses.....	1,900
Gain on sale of refrigerator.....	350
Fire loss on store building.....	1,200
Net operating loss carryover.....	1,000

To figure taxable income, all the above items are considered. But to figure **net earnings from self-employment**, use only the following:

Gross profit on sales.....	\$87,400
Expenses:	
Salaries.....	30,000
Rent.....	6,000
Heat, light, and air conditioning.....	2,400
Other expenses.....	1,900
Total expenses.....	40,300
Net operating profit.....	\$47,100

The \$47,100 is your net earnings from self-employment. The sale of the refrigerator, the fire loss, and the net operating loss carried over from a previous year are not included in the calculation.

Step 2. After you have figured your net earnings from self-employment, determine how much of those earnings you have to pay the tax on. There is both a minimum and a maximum income limit.

Minimum income. Generally, you must have \$400 or more of net earnings from self-employment to be subject to the tax. If your net earnings are less than \$400, you do not have to file a Schedule SE (Form 1040) or pay the tax. (An employee of a church or qualified church-controlled organization that is exempt from social security taxes must pay the self-employment tax if the employee is paid \$100 or more in a year.)

Maximum income. No more than \$39,600 of your net earnings in 1985 is subject to any combination of self-employment tax, social security tax, or railroad retirement tax. If you have more than \$39,600 in income, you pay these taxes only on \$39,600. The amount increases to \$42,000 for 1986.

If you have wages in 1985 that are subject to either social security tax or railroad retirement tax, or both, subtract the total of these wages from \$39,600 to arrive at the maximum amount subject to self-employment tax. If your wages are subject to social security tax, railroad retirement tax, or both, and total at least \$39,600, you do not have to pay self-employment tax.

In 1985 if you were a U.S. Government employee subject only to the 1.35% hospital insurance benefits tax, and your combined wages and self-employment earnings were in excess of \$39,600, compute your self-employment tax by using the worksheet in the Form 1040 instructions for Schedule SE.

Step 3. After you determine how much of your net earnings are subject to the self-employment tax, multiply that amount by the tax rate for 1985 of 11.8% (14.1% - 2.3% credit = 11.8%). The result is the amount of self-employment tax you owe.

Example 1. During 1985, you have \$42,000 of net earnings from self-employment and received no wages subject to social security tax. Since only \$39,600 of your income is subject to self-employment tax, your self-employment tax is 11.8% (.118) of \$39,600, or \$4,672.80.

Example 2. During 1985, you have \$42,000 in net earnings from self-employment and also receive \$2,200 in wages subject to social security tax. Only \$37,400 (\$39,600 - \$2,200) of your self-employment net earnings is subject to tax. Your tax is 11.8% of \$37,400, or \$4,413.20. If during 1985 your net earnings from self-employment are only \$3,000, then the entire \$3,000 is subject to self-employment tax, and your tax is 11.8% of \$3,000, or \$354.

Example 3. During 1985, you have net earnings from self-employment of \$24,000 and wages subject to social security tax of \$16,000. You pay self-employment tax on only \$23,600 (\$39,600 - \$16,000) of the \$24,000. Your tax is 11.8% of \$23,600, or \$2,784.80.

Fiscal year taxpayer. If you use a tax year other than the calendar year, you must use the tax rate and maximum income limit that are in effect at the beginning of your tax year. Even if the tax rate or maximum income limit changes during your tax year, you should continue to use the same rate and limit throughout your tax year.

Nonfarm Optional Method

By using the nonfarm optional method, you can continue your self-employment tax coverage when your net profit for the year is small or

you have a loss. But you may not use this method to report an amount less than your actual net earnings from self-employment.

The nonfarm optional method is used only for self-employment income that does not come from farming. You may use this method if you meet all the following tests.

- 1) Your actual net earnings from nonfarm self-employment, as figured by the regular method, are less than \$1,600.
- 2) Your net earnings from nonfarm self-employment are less than two-thirds of the total gross income you made from nonfarm self-employment.
- 3) You are self-employed on a regular basis. Self-employment on a regular basis means that your actual net earnings from self-employment are \$400 or more in at least 2 of the 3 tax years before the one for which you use this method.
- 4) You have not previously used this method more than 4 years (there is a 5 year lifetime limit).

If your gross income from all nonfarm trades or businesses is \$2,400 or less and you meet the four tests in the preceding paragraph, you may report two-thirds of the gross income from your nonfarm business as net earnings from self-employment.

Example 1. Ann Green had actual net earnings from self-employment of \$400 or more in 1983 and 1984 from her grocery store. She, therefore, meets the test for being self-employed on a regular basis. Her earnings from the grocery business in 1985 are as follows:

Gross income.....	\$1,200
Net earnings.....	\$ 400

Because her actual net earnings from self-employment are less than \$1,600 and less than two-thirds of her total gross nonfarm income, Ann either may report her actual net earnings of \$400 for 1985 or she may use the optional method to report \$800 (two-thirds of \$1,200).

Example 2. Assume that in Example 1 Ann has a gross income of \$1,000 and her net earnings are \$800. She must report her actual net earnings of \$800. She may not use the optional method because her actual net earnings are not less than two-thirds of her gross income.

Example 3. Assume that in Example 1 Ann has a net loss of \$700. In this situation, she may choose to report \$800 (two-thirds of \$1,200) as her net earnings under the optional method.

Example 4. Assume that in Example 1 Ann had a gross income of \$525 and net earnings of \$175. In this situation, she cannot use the optional method to pay the self-employment tax because two-thirds of her gross income (\$350) is less than the minimum income requirement of \$400.

If your gross income from all nonfarm trades or businesses is more than \$2,400 and you meet the four tests for using the nonfarm optional method, you may report \$1,600 as your net earnings from nonfarm self-employment.

Example 1. John White runs an appliance repair shop. His net earnings from self-employment in 1982 were \$8,500; in 1983, \$10,500; and in 1984, \$9,500. He therefore meets the test for being self-employed on a regular basis. His earnings in 1985 are as follows:

Gross income.....	\$2,800
Net earnings.....	\$ 800

Because his actual net earnings from self-employment (\$800) are less than \$1,600 and less than two-thirds of his gross income, John may

choose to report \$1,600, as his net earnings from self-employment for 1985, or he may report \$800 under the regular method.

Example 2. Assume that in Example 1 John's net earnings for 1985 are \$1,700. He must report the full \$1,700 as figured under the regular method. He may not use the optional method because his actual net earnings from self-employment are not less than \$1,600.

Example 3. Assume that in Example 1 John has a net loss of \$700 for 1985. He may use the optional method and report \$1,600 as his net earnings from self-employment.

Figuring the tax. After you have determined your net earnings under the nonfarm optional method, check to see whether the earnings meet the minimum income requirement of \$400. If they do, multiply the net earnings figure by the tax rate for 1985 (11.8%). The result is the amount of self-employment tax you owe.

Farm Optional Method

If you are in the farming business, either as an individual or in a partnership, you may be able to use the farm optional method to figure your net earnings from farm self-employment. Like the nonfarm method, this method also allows you to continue coverage for self-employment tax when your net profit for the year is small or you have a loss.

There are fewer restrictions on using this method than there are for the nonfarm optional method. There is no test of regular self-employment nor is there a requirement that your actual net earnings be less than two-thirds of your gross income. There is also no limitation on the number of years you may use this method.

If your gross income from farming is \$2,400 or less, you may report two-thirds of your gross income as your net earnings from farm self-employment.

If your gross income from farming is more than \$2,400, and your actual net earnings from farm self-employment are less than \$1,600, you may report \$1,600 as your net earnings from farm self-employment. But if gross income from farming is more than \$2,400 and your actual net earnings from farm self-employment are \$1,600 or more, you must use your actual net earnings to determine your self-employment tax.

Gross income from farming. Farming income includes what you receive from cultivating the soil or raising or harvesting any agricultural commodities. It also includes income from the operation of a livestock, dairy, poultry, bee, fish, fruit, or truck farm, or plantation, ranch, nursery, range, orchard, or oyster bed and income you get in the form of crop shares if you materially participate in production or management of production. For more information, see Publication 225, *Farmer's Tax Guide*.

Your gross income will not include any item listed as being excluded under the *Regular Method*, earlier. When you use the farm optional method, you must also exclude income, deductions, and losses that come from any nonfarm business. Government commodity program payments that you receive on land you rent out are not included unless you meet the material participation test.

If you file your return on the *cash method* and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 31 of Schedule F.

If you file your return on the *accrual method* and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 87 of Schedule F.

Gross income from a farming partnership. Your gross income under the farm optional method includes your distributive share of a partnership's gross income from farming.

To determine your distributive share of gross income from a farming partnership:

- 1) Figure the partnership's gross income from farming.
- 2) Subtract any guaranteed payments to partners for services or for the use of capital if the payments are determined without regard to partnership income.
- 3) Determine your share of what is left. The gross income that remains after steps one and two is divided among the partners in the same way that they share in the ordinary income or loss of the partnership unless the partnership agreement provides otherwise.
- 4) Add any guaranteed payments that you receive from the partnership that are determined without regard to partnership income. The total you arrive at after these steps will give you your share of partnership gross income.

Figuring the tax. If your net earnings under the farm optional method are \$400 or more, multiply the net earnings figure by the tax rate for 1985 (11.8%). The result is the amount of self-employment tax you owe.

Optional earnings less than actual earnings. If your net earnings under the farm optional method are less than your actual earnings, you can still use the farm optional method. For example, your actual self-employment net earnings are \$425 and your net earnings figured under the farm optional method are \$360. You owe no self-employment tax if you use this method, since your net earnings fall below \$400. However, if you want to maintain your social security coverage, you could use your actual net earnings to determine your self-employment tax.

Using Both Methods

You may not combine income from farming with nonfarm income in arriving at your net earnings under either of the optional methods. If you use both methods, you must add together the net earnings figured under each method to come up with your total self-employment net earnings. You may report less than actual total net earnings but not less than actual net earnings from nonfarm self-employment alone when using both options. You may report no more than \$1,600 as your net earnings from self-employment.

Example 1. You are a self-employed farmer. You also operate a retail grocery store. Your 1985 gross income, actual net earnings, and optional farm and nonfarm net earnings from self-employment are as follows:

	Gross income	Net earnings	2/3 of gross income
Farm.....	\$1,200	\$900	\$ 800
Nonfarm.....	1,500	500	1,000

Your 1985 net self-employment earnings may be figured in any of the four ways shown below:

	1	2	3	4
Actual farm net earnings.....	\$ 900	—	\$ 900	—
Optional farm net earnings.....	—	\$ 800	—	\$ 800
Actual nonfarm net earnings.....	500	500	—	—
Optional nonfarm net earnings.....	—	—	1,000	1,000
Net earnings.....	\$1,400	\$1,300	\$1,900	\$1,800*

*Limited to \$1,600 because both the farm optional and the nonfarm optional methods are used.

Example 2. Assume that in Example 1 your gross income, net earnings, and optional farm and nonfarm net earnings from self-employment are as follows:

	Gross income	Net earnings	2/3 of gross income
Farm	\$2,600	\$400	\$1,733
Nonfarm	1,000	800	667

Your 1985 self-employment earnings may be either of the amounts figured below:

	1	2
Actual farm net earnings	\$ 400	—
Optional farm net earnings	—	\$1,600*
Actual nonfarm net earnings	800	800
Optional nonfarm net earnings	—	—
Net earnings	\$1,200	\$2,400

*Limited to \$1,600.

The nonfarm optional method may not be used for 1985 because your actual net earnings from nonfarm self-employment (\$800) are not less than two-thirds of gross nonfarm profit (2/3 of \$1,000, or \$667).

Earned income credit. If you use either of the

optional methods discussed in this section, you may be able to claim the earned income credit. To find out if you qualify, you should fill out the *Earned Income Credit Worksheet* that is part of the instructions for Form 1040.

Example of Schedule SE

Susan J. Brown is sole proprietor of a dress shop, "Milady Fashions." Her Schedule C (Form 1040) shows a net profit of \$35,100 in 1985. Susan's completed Schedule SE (Form 1040) is shown at the end of this publication.

If Susan were the sole proprietor of more than one business, she would have combined the profits and losses from all of them and filled out only one Schedule SE. If, in addition to operating her dress shop, Susan had worked for wages totaling \$39,600 or more in 1985, she would not have filled out Schedule SE. Susan's employer would have already withheld the maximum amount of social security tax owed.

Susan's Schedule SE does not have her husband's name on it. Since her husband has no interest in her business, he does not pay self-employment tax on this income or get social security credit for the tax that Susan pays. If her husband has self-employment income of his own, he will file a separate Schedule SE.

The line numbers shown below in bold type

refer to the line numbers on the sample filled-in Schedule SE on the following page.

Line 1. Since Susan has no earnings from farm self-employment, she leaves line 1 blank.

Line 2. Susan enters the net profit from her Schedule C, \$35,100, on line 2.

Lines 4—6. Susan does not fill in lines 4 through 6 because she does not qualify to use either of the optional methods.

Line 8. Susan brings the amount on line 2 to line 8. Then, because she has no farm income, Susan enters the same amount on line 9.

Line 13. If Susan had received any wages or tips subject to social security tax or railroad retirement tax, she would have entered the amount of such wages or tips on line 11a or line 11b and subtracted the total from \$39,600. This is the maximum on which social security tax, railroad retirement tax, and self-employment tax may be paid. Since she has no wages or tip income, she brings the \$39,600 on line 10 down to line 12a. Since line 12a is more than line 9, she enters \$35,100 on line 13.

Line 14. Susan now figures her self-employment tax. She multiplies the \$35,100 on line 13 by the tax rate (11.8%). She enters this amount, \$4,141.80, on line 14. This is the amount of self-employment tax she owes. She enters the amount on line 51 of Form 1040.

SCHEDULE SE
(Form 1040)

Department of the Treasury
Internal Revenue Service

Computation of Social Security Self-Employment Tax

▶ See Instructions for Schedule SE (Form 1040).
▶ Attach to Form 1040.

OMB No. 1545-0074

1985

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Name of self-employed person (as shown on social security card)

SUSAN J. BROWN

Social security number of
self-employed person ▶

123 00 6789

Part I Regular Computation of Net Earnings From Self-Employment

Note: If you performed services for certain churches or church-controlled organizations and you are not a minister or a member of a religious order, see the instructions.

- 1 Net farm profit or (loss) from Schedule F (Form 1040), line 39, and farm partnerships, Schedule K-1 (Form 1065), line 13a
- 2 Net profit or (loss) from Schedule C (Form 1040), line 33, Schedule K-1 (Form 1065), line 13a (other than farming), and Form W-2 wages of \$100 or more from an electing church or church-controlled organization. (See instructions for other income to report.)

Note: ☐ Check here if you are exempt from self-employment tax on your earnings as a minister, member of a religious order, or Christian Science practitioner because you filed Form 4361. See instructions for kinds of income to report. If you have other earnings of \$400 or more that are subject to self-employment tax, include those earnings on line 2.

1		
2	35,100	00

Part II Optional Computation of Net Earnings From Self-Employment
(See "Who Can Use Schedule SE")

Generally, this part may be used **only** if you meet any of the following tests:

- A Your gross farm income (Schedule F (Form 1040), line 12) was not more than \$2,400; or
- B Your gross farm income (Schedule F (Form 1040), line 12) was more than \$2,400 and your net farm profits (Schedule F (Form 1040), line 39) were less than \$1,600; or
- C Your net nonfarm profits (Schedule C (Form 1040), line 33) were less than \$1,600 and also less than two-thirds ($\frac{2}{3}$) of your gross nonfarm income (Schedule C (Form 1040), line 5).

See instructions for other limitations.

3 Maximum income for optional methods	3	\$1,600	00
4 Farm Optional Method—If you meet test A or B above, enter: the smaller of two-thirds ($\frac{2}{3}$) of gross farm income from Schedule F (Form 1040), line 12, and farm partnerships, Schedule K-1 (Form 1065), line 13b; or \$1,600	4		
5 Subtract line 4 from line 3	5		
6 Nonfarm Optional Method—If you meet test C above, enter: the smallest of two-thirds ($\frac{2}{3}$) of gross nonfarm income from Schedule C (Form 1040), line 5, and Schedule K-1 (Form 1065), line 13c (other than farming); or \$1,600; or, if you elected the farm optional method, the amount on line 5	6		

Part III Computation of Social Security Self-Employment Tax

7 Enter the amount from Part I, line 1, or, if you elected the farm optional method, Part II, line 4	7		
8 Enter the amount from Part I, line 2, or, if you elected the nonfarm optional method, Part II, line 6	8	35,100	00
9 Add lines 7 and 8. If less than \$400, do not fill in the rest of the schedule because you are not subject to self-employment tax. (Exception: If this line is less than \$400 and you are an employee of an electing church or church-controlled organization, complete the schedule unless this line is a loss. See instructions.)	9	35,100	00
10 The largest amount of combined wages and self-employment earnings subject to social security or railroad retirement tax (Tier 1) for 1985 is	10	\$39,600	00
11 a Total social security wages and tips from Forms W-2 and railroad retirement compensation (Tier 1). Note: U.S. Government employees whose wages are only subject to the 1.35% hospital insurance benefits tax (Medicare) and employees of certain church or church-controlled organizations should not include those wages on this line (see instructions).	11a		
b Unreported tips subject to social security tax from Form 4137, line 9, or to railroad retirement tax (Tier 1)	11b		
c Add lines 11a and 11b	11c		
12 a Subtract line 11c from line 10.	12a	39,600	00
b Enter your "qualified" U.S. Government wages if you are required to use the worksheet in Part III of the instructions. 12b	12b		
c Enter your Form W-2 wages from an electing church or church-controlled organization. 12c	12c		
13 Enter the smaller of line 9 or line 12a	13	35,100	00
If line 13 is \$39,600, fill in \$4,672.80 on line 14. Otherwise, multiply line 13 by .118 and enter the result on line 14		.118	
14 Self-employment tax. Enter this amount on Form 1040, line 51	14	4,141	80

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule SE (Form 1040) 1985

How to Get IRS Forms and Publications

You can order federal tax forms and publications from the IRS Forms Distribution Center for your state at the address below. Or, if you prefer, you can photocopy tax forms from reproducible copies kept at many participating public libraries. In addition, many of these libraries have reference sets of IRS publications which you can also read or copy—on the spot.

Alabama—Caller No. 848, Atlanta, GA 30370

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